TONBRIDGE & MALLING BOROUGH COUNCIL

FINANCE and PROPERTY ADVISORY BOARD

21 July 2010

Report of the Director of Finance

Part 1- Public

Matters for Recommendation to Cabinet - Non-Key Decision

1 TREASURY MANAGEMENT UPDATE

This report provides an overview of treasury management activities undertaken during the financial year to-date in the context of the national economy and invites Members to recommend endorsement of the action taken to Cabinet.

1.1 Introduction

1.1.1 CIPFA issued a revised Code of Practice for Treasury Management in November 2009. The revised Code was adopted by the Council on 18 February 2010 and suggests that Members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This report, therefore, ensures this Council is embracing Best Practice in accordance with CIPFA's revised Code of Practice.

1.1.2 As part of the adoption process I committed to reviewing and re-issuing our Treasury Management Practices (TMPs). I am pleased to advise Members that the review has now been completed and the new TMPs were subject to scrutiny by the Audit Committee on 21 June 2010.

1.2 Economic Background

1.2.1 The first six months of 2010 saw:

- The first official estimate of UK GDP for 2010 indicating the economy had managed to avoid a 'double-dip' recession and expand at 0.3% during the first quarter;
- Retail sales proving to be volatile after being hit by bad weather and the VAT increase in January and fell by 2.3% in April;
- The recovery continued to fail to create new jobs, despite which unemployment is expected to hold at 8% before starting to decline;
- Pay growth remaining weak;
- The UK's trade position begin to improve, helped by the weak pound;

- House prices edging upwards, perhaps more because of a shortage of supply rather than a general increase in prices. A view which seems to be borne out by the continued low volume of mortgage approvals;
- The former Chancellor revise downwards his forecast for public sector borrowing in the Budget;
- The Monetary Policy Committee pause QE and keep official interest rates on hold at 0.5% in June;
- The CPI and RPI inflation indices peak in April at 3.7% and 5.3%.

1.2.2 The Monetary Policy Committee (MPC) response to all of the above signals was to vote to keep official interest rates on hold at 0.5% in June and to continue to pause its programme of quantitative easing (QE).

1.3 Interest Rate Forecast

1.3.1 The Council's Treasury Advisor, Sector, provides the following forecast:

	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.50%	0.75%	1.00%	1.50%	1.75%	2.25%	2.50%	3.00%	3.50%	3.75%
5yr PWLB rate	2.90%	2.95%	2.95%	3.15%	3.30%	3.50%	3.60%	3.95%	4.30%	4.55%	4.70%	4.80%
10yr PWLB rate	4.20%	4.30%	4.40%	4.45%	4.55%	4.60%	4.65%	4.70%	4.75%	4.90%	4.95%	5.10%
25yr PWLB rate	4.65%	4.70%	4.75%	4.75%	4.85%	4.90%	5.00%	5.05%	5.15%	5.20%	5.25%	5.25%
50yr PWLB rate	4.65%	4.70%	4.75%	4.80%	4.90%	4.95%	5.05%	5.05%	5.20%	5.25%	5.25%	5.25%

1.3.2 The forecast is based upon the following assumptions:

- Moderate economic recovery and MPC inflation forecast being below target in two years' time;
- The first Bank Rate increase coming in 2011; and reaching 3.75% by March 2013;
- Long term PWLB rates are expected to steadily increase to reach 5.25% by late 2012 due to huge gilt issuance, reversal of QE and investor concerns over inflation;
- The balance of risks is weighted to the downside; and
- There is still some risk of a "double dip" recession.

1.3.3 There is considerable uncertainty in all forecasts due to the difficulties of forecasting the timing and amounts of QE reversal, the fiscal effect of the Government's £6.2 billion savings and emergency budget announcements, speed of recovery of banks profitability and balance sheet position, changes in the consumer saving ratio and the rebalancing of the UK economy in terms of export and import.

1.4 Treasury Management Performance

1.4.1 The Treasury Management Strategy Statement (TMSS) for 2010/11 was approved by Council on 18 February 2010. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of Capital
- Liquidity

1.4.2 The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term, and to only invest with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Sector.

1.4.3 A full list of investments held as at 2 July 2010, a copy of the most recent counterparty lists and the Sector monthly report on internally managed investments to the end of May, are shown in **[Annexes 1 to 3]** of this report.

1.4.4 As illustrated in the economic background section above, investment rates available in the market are at an historical low point. The average level of cash flow funds available for investment purposes to the end of May 2010 was £9.0m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme. The authority holds £21.5m of core cash balances for investment purposes, of which £16.5m is managed by our external fund manager. These funds are for the most part available to invest for more than one year, albeit that around £3m will need to be recalled during 2010/11 to fund the capital programme.

1.4.5 As at the end of May funds invested and interest earned is set out in the table below:

	Funds invested at 28 May 2010 £m	**Average maturity years**	**Gross return %**	**7 Day Libid Benchmark %**	**Interest earned £**
In-house cash flow – excl of Landsbanki	8.3	0.01	0.68	0.49	10,300
In-house core funds	5.0	1.06	6.65	0.49	55,600
Externally managed core funds	16.6	0.32	0.50	0.49	13,100
Total	29.9	0.36	1.59	0.49	79,000

1.4.6 The authority outperformed the benchmark by 110 basis points (bp). The key contribution to that out-performance came from two internally managed core investments with Barclays and Nationwide.

1.4.7 Attention is drawn to the fact that the time to maturity for the Barclays and Nationwide investments exceeds the 6 month duration rating suggested by Sector and, therefore, applicable in respect of new investments undertaken in accordance with the Treasury Management Strategy for 2010/11. The Treasury Management Team continue to monitor these investments closely and consider that the implicit support of HMG for those counterparties provides sufficient comfort to not call for premature repayment.

1.4.8 Our daily cash flow balances for the year ahead are modelled at the start of the financial year. That cash flow model is then updated daily and reviewed on a regular basis to identify opportunities to make longer term investments using surplus cash flows. In June, four fixed term investments were made with UK banks and building societies to take advantage of the higher yields available. The investments of £1.5m each with the Bank of Scotland, Lloyds TSB, Barclays and the Nationwide are shown in **[Annex 1]**. Each investment complies with the duration limit recommended by Sector.

1.4.9 Investec's performance to the end of May is marginally above benchmark. Their performance is monitored by Sector, our Treasury Advisors, on a quarterly basis. The report for the quarter ending June will be available early August and will include a comparison with the performance achieved by other fund managers used by Sector clients. If any issues arise from that report they will be addressed by the Treasury Management Team at a meeting with Investec scheduled for 19 August 2010.

1.5 Treasury Management Practices

1.5.1 The CIPFA Code of Practice for Treasury Management recommends that suitable Treasury Management Practices (TMPs) are created as the cornerstones for effective treasury management. These TMPs are required to set out the manner in which the Council will seek to achieve its policies and objectives and to prescribe how those activities will be managed and controlled.

1.5.2 The latest version of the Treasury Management Practices, Schedules and List of Available Evidence were reviewed by the Audit Committee at its meeting on 21 June 2010. At the last meeting of this Advisory Board, Members expressed a desire to see the TMPs and associated documents. The TMPs as recommended to Cabinet for adoption by the Audit Committee are shown in **[Annexes 4 to 7]**.

1.6 Borrowing

1.6.1 It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits" by way of the Prudential Indicators (affordability limits) set out in the approved TMSS. In this regard it is confirmed that no borrowing was undertaken in the Period April to June 2010.

1.7 Legal Implications

1.7.1 The position regarding the Council's Landsbanki deposit is as reported to the May meeting of this Advisory Board. The contract with Landsbanki remains in default and action is now being taken by Bevan and Brittan, our legal advisors, to confirm local authority depositors' status as **priority creditors**. It is expected local authorities' cases will be referred to court shortly. A number of authorities have been selected by the Winding Up Boards as "Test Cases" in order to allow the full range of issues to be argued before the Icelandic courts. The subsequent judgements will not be automatically binding on other cases. Therefore, to ensure the earliest possible resolution of matters for all authorities, the winding up boards have been invited to refer all authorities' claims to the court now.

1.7.2 As the court processes in Iceland are likely to take around 12 months, it is not expected that any part of the defaulted investment will be repaid during this financial year.

1.8 Financial and Value for Money Considerations

1.8.1 Despite the outperformance against the benchmark, returns to the end of May fell short of the budgeted investment return of £100,100 by just over £21,000. Members should be aware that the shortfall is likely to increase as the year progresses if, as is now expected, interest rates remain abnormally low for the remainder of the financial year and Barclays exercise their option to seek to repay their high coupon loan in July.

1.8.2 A variation to the budget for investment income is, therefore, likely and this will be brought forward to Members for consideration at the revised estimate stage.

1.8.3 Investec's performance will be considered by the Treasury Management Team at the next review meeting with Investec scheduled for August 2010.

1.9 Risk Assessment

1.9.1 The application of best practice, in the form of regular reporting and scrutiny of treasury management activities, as identified by the CIPFA Code is considered to be the most effective way of mitigating the risks associated with treasury management.

1.9.2 In respect of the Landsbanki investment participation in the joint action co-ordinated by the Local Government Association is still thought to offer the greatest chance of recovering the defaulted loan and associated interest.

1.9.3 At this time the added risk associated with continuing to hold the in-house core investments with Barclays and Nationwide beyond the duration rating suggested by Sector is not thought to outweigh the loss of income that would result from seeking early repayment.

1.10 Recommendations

1.10.1 Members are **RECOMMENDED** to:

1) Endorse the action taken by officers in respect of recent treasury management activities; and to

2) **RECOMMEND** that Cabinet do likewise.

Background papers: contact: Mike Withey

Nil

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